***United States Court of Appeals***

***for the Second Circuit***

# APPELLANT'S REPLY BRIEF

ORIGINAL

# 76-7600

*To be argued by*
Clarence Fried

# United States Court of Appeals

## FOR THE SECOND CIRCUIT

J. P. FOLEY & COMPANY, INC., JOHN P. FOLEY, JR., ANNE A. FOLEY, and ANITA SALISBURY,

*Plaintiffs-Appellants,*

*against*

NEW YORK STOCK EXCHANGE, and AMERICAN STOCK EXCHANGE,

*Defendants-Appellees.*

On Appeal from the United States District Court For the Southern District of New York

## REPLY BRIEF FOR PLAINTIFFS-APPELLANTS

Hawkins, Delafield & Wood
*Attorneys for Plaintiffs-Appellants*
67 Wall Street
New York, New York 10005

Clarence Fried
Robert R. MacDonnell
Samuel Turetsky
*Of Counsel*

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## REPLY BRIEF FOR PLAINTIFFS-APPELLANTS

### Factual Errors in Appellees' Briefs

Although appellee New York Stock Exchange [hereinafter "the Exchange"] has asserted that appellants' statement of facts was selective and inaccurate, a review of the record clearly indicates that it is appellees who have presented a factually distorted view of the occurrences herein. Thus, appellees* have made the following inaccurate statements:

a) At page 5 of its brief, the Exchange has attempted to raise the inference that Dr. Foley was a sophisticated and knowledgeable investor, by asserting that he had advised

* References are to the Exchange's brief but are equally applicable to the American Stock Exchange which adopted the Exchange's statement of facts (Br. 4).

brokerage houses and was aware of the operational and financial difficulties being experienced by said firms. In actuality, the evidence indicated that Dr. Foley had never been in the securities business (A 32) and that the consulting services he performed for brokerage houses had to do with

> ". . . employee relations, ontesting and interviewing and other aspects of an overall selection program, the training of interviewers . . . the use of tests and interviews in the evaluation of personnel, the conduct of employee and attitude morale surveys." (A 33)

In other words, Dr. Foley's experience with brokerage houses prior to his dealings with Blair & Co. [hereinafter "Blair"] was solely related to the area of his specialty—psychology. Moreover, the only knowledge that Dr. Foley had concerning problems in the brokerage field was what he had read in the paper. (A 111)

b) Again at page 5 of its brief, the Exchange asserts that Dr. Foley stated "it was timely to invest in a brokerage house because it was a 'turnaround situation'." Review of the reference to the Record cited by the Exchange to support its attribution of the turnaround situation to Dr. Foley reveals that Dr. Foley never used that term but rather that it was an *impression* received by James Rush from his general discussions of Blair and the brokerage industry as a whole with Dr. Foley. In fact, Dr. Foley testified that he had never purchased any securities in a distress situation (A 34) and was not a trader. (A 116) Many of his security holdings were in companies which were his clients. (A 34)

c) Contrary to every inference contained in the Exchange's brief, the evidence established exactly what the court stated in an unsolicited comment:

> "Dr. Foley has not testified that he was in the investment community." (A 138)

d) Throughout its brief, and particularly at pages 6 and 7 thereof, the Exchange states that Dr. Foley was aware of the financial and operational difficulties Blair was experiencing. What the Exchange does not state is that:

1. In February, Dr. Foley was told by Blair Treasurer James Rush that the company ". . . would be in the black by May 1st, and by June 1st for sure, for certain." (A 54);

2. That Dr. Foley was told that Blair had hired George Morpurgo, an expert in the Mid-West system, in early 1970 and that Morpurgo would clear up Blair's books and records problem (A 53-54; 124); and

3. With respect to Blair's compliance with the net capital rule, Rush told Dr. Foley that ". . . with the deposit of our [Foley's] securities, they would be in full compliance." (A 56)

e) At page 7 of its brief, the Exchange refers to the extraordinary nature of the Foley agreement. Rather than being extraordinary, the evidence established that while the Exchange could have approved an interest rate of 8% with respect to the Foley investment, appellants received only 3% under their agreement (A 126);

f) At page 12 of its brief, the Exchange states that Dr. Foley was familiar with an Exchange letter dated March 10th which referred to the fact that it was impossible to compute Blair's capital position. In fact, Dr. Foley testified on cross-examination that he had not seen that letter until subsequent to commencement of litigation. (A 161)

Although the Exchange's brief contains many other factual errors, its most grievous flaw is not found in a misstatement but rather in its glaring failure to explain the Exchange's actions prior to and on April 3, the date of the closing. Although the Exchange has piously attempted to divorce itself from the fraud perpetrated upon appellants, nowhere has it refuted the fact that it:

1. was involved and aware of the Foley negotiations from the outset;

2. was aware of the misstatements contained in Financial Report which lacked credibility because Blair's books and records were out of control;

3. had instructed Blair to obtain additional capital [from Dr. Foley] and permitted Blair to continue to function in the interim by approving a "stopgap" infusion of capital [Ireland's funds];

4. had placed a crew of their own auditors in Blair to control its financial condition; (A 1189) and

5. had advised Blair, but not Dr. Foley, on April 3, during the closing, that Foley's capital would not place Blair in compliance with the Exchange's net capital rule and that it had directed that a liquidation of the insiders' securities would commence the first business day following the closing. (PX 64, E 336)

Under all of the circumstances involved herein, it is respectfully submitted that where the appellants have established that the Exchange had full knowledge of all the facts, directly monitored Blair's operations, directed Blair's solicitation of appellants' investment and failed to advise appellants of the liquidation decree as appellants were closing with Blair and long before appellants' securities were turned over to Blair, the Exchange cannot claim as a matter of law its lack of 10(b) responsibility.

## POINT I

### The exchange owed a duty to inform Foley

In Point I of its brief, the Exchange, relying almost exclusively upon this Court's recent decisions in *Hirsch* v. *duPont*, Fed. Sec. L. Rep. (CCH) ¶ 96,011 (2nd Cir. 1977)

and *Murphy* v. *McDonnell & Co.*, Fed. Sec. L. Rep. (CCH) ¶ 96,021 (2nd Cir. 1977), has argued that it owed no duty to convey information to Foley. However, it is respectfully submitted the above decisions are clearly distinguishable from the instant case and are not dispositive of the issues involved herein.

### A. *Hirsch v. DuPont*

1) In *Hirsch,* Judge Kaufman, on several occasions, referred to the plaintiffs' long experience in the field of securities, e.g., "All of these men were wise in the ways of Wall Street as a result of long and prosperous experience." The plaintiffs, in *Hirsch* were, in fact, managing partners of a major securities firm. The Record in the instant case evidences that appellants were not sophisticated investors, were not in the securities industry and were not knowledgeable concerning the operations of brokerage houses.

2) In *Hirsch,* the Record was filled with references to the information which was available to the plaintiffs, i.e., "This information (duPont's capital deficiency) was, of course, available to anyone who chose to inspect SEC records and perform the necessary calculations." In this case, the financial information* was only available through Blair and the Exchange, and the Exchange had grave doubts about the reliability of the information (E 91-92).

3) The plaintiffs in *Hirsch,* contemplating a merger between two major securities firms, conducted a detailed investigation, through their own expert, of duPont's capital situation, and were aware of its "back office" problems. On that basis, the trial judge found that the information which the Exchange failed to disclose regarding duPont's capital deficiency was not material. Appellants, unlike the plaintiffs in *Hirsch,* lacked access to Blair's books and rec-

* inaccurate as it was, i.e. $10 million either way (A 460-61).

ords, and had been seriously misled by Blair's fraudulent financial statement. Appellants had neither the opportunity nor expertise to conduct a meaningful detailed investigation, and, in fact, had a right to rely not only on full disclosure by Blair, but also by the Exchange, which was actually involved in Blair's day-to-day operations. More importantly, appellants had been specifically advised that Blair would be in the black by May or June, for certain, and that an expert had been hired to clear up the "back office" problems. With the knowledge and acquiescence of the Exchange, appellants had been further advised that Blair's net capital problems would be over with their infusion of capital.

4) The Court in *Hirsch* found that the Exchange, ". . . did not play a part—not even a minor part—in the merger between Hirsch and duPont." In this case, the Exchange directed Blair to solicit new capital, permitted dissemination of a fraudulent Financial Statement, acquiesced in and directed the infusion of "stopgap" capital and failed to advise appellants of the liquidation of insider securities scheduled to commence one business day after they closed, all to protect its own Special Trust Fund.

**B. *Murphy v. McDonnell & Co.***

1) The plaintiffs in *Murphy* attempted to impose liability on the Exchange under Sections 6 and 10(b). After dismissing the Section 6 claim because the plaintiffs were subordinated lenders, the Court ruled that absent knowledge of the fraud and participation by the Exchange in the transaction or concealment there could be no Section 10(b) liability. According to the Court, it was clear that there was neither knowledge nor participation. As has been demonstrated above, in this case there was more than mere nondisclosure; specifically, the direct participation of the Exchange in the operations of Blair and in efforts to procure the capital contribution from appellants.

The Court in *Murphy* simply held that the Exchange had no duty to warn sophisticated lenders. Such a holding has no relevance to the instant case, where the evidence has demonstrated the Exchange's complicity in the fraud perpetrated upon appellants.

Additionally, in both *Hirsch* and *Murphy,* the plaintiffs stood in positions where the information available to them was at least as good as that possessed by the Exchange. In *Hirsch,* they were the managing partners of one of the firms engaged in merger negotiations. As such, they had access to detailed financial information. In *Murphy,* the plaintiffs were subordinated lenders of the firm and related to the firm's President and Managing Partner. The situation here is markedly different. Appellants were not in the securities business and were not subordinated lenders of Blair at or about the time they were defrauded. They were nothing more than wealthy, rather unsophisticated, potential investors who were misled into a relationship with a dying, if not already dead, brokerage house.

*Hirsch* and *Murphy* appear to expand this Court's prior recent holdings by indicating that the Exchange, absent some participation in the transaction, owes no duty of disclosure to an insider of any information it has regarding a member firm. It is appellants' contention that the evidence submitted below was sufficient to establish participation by the Exchange, thereby making the Exchange's transgressions that of an aider and abettor under Section 10(b). *Fischer* v. *New York Stock Exchange,* 408 F. Supp. 745 (S.D.N.Y. 1976).

## CONCLUSION

**For all of the reasons set forth by appellants, the judgments below should be reversed.**

Respectfully submitted,

HAWKINS, DELAFIELD & WOOD
*Attorneys for Plaintiffs-Appellants*

CLARENCE FRIED
ROBERT R. MACDONNELL
SAMUEL TURETSKY
*Of Counsel*

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~~Due and timely~~ Service of TWO copies of the within BRIEF is hereby admitted this 20TH day of MAY 1977

Milbank Tweed Hadley & McCloy

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Attorneys for APPELLEE
NEW YORK STOCK EXCHANGE

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ATTORNEYS FOR APPELLEE
AMERICAN STOCK EXCHANGE

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LORD, DAY & LORD

ATTORNEYS FOR Amex